Pennsylvania Online Poker: An Overview of the Policy Environment, Operational Controls, and Why Online Poker is Important for Licensees and the Commonwealth

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Policy Environment

Milestones in the recent history of U.S. online gambling – the reality

- **Today's Reality** – Millions of Americans in all 50 states gamble on the Internet, notwithstanding laws that prohibit/regulate such activity.

- See www.pokerscout.com

  - **It most frequently occurs with no consumer protections**
    - **no protections against underage gambling;**
    - **no protections for problem gamblers;**
    - **ripe for fraud and criminal activity; and**
    - **no tax collections from illegal market.**
  - It occurs in Pennsylvania every day

- **Growth of Internet gambling consistent with growth of eCommerce** - period of growth beginning in the 1990s - Market was $300 million in 1997
  - Market grew to $4 - $6 billion by 2010 with some shrinkage post 2011 indictments

- **Illegal Operators** - Market dominated by rogue offshore operators in defiance of U.S. and state laws

Milestones in the recent history of U.S. online gambling - the law

- **Wire Act** - Since 1960's, the federal Wire Act been applied to gambling that occurs across state lines via telephone and later the Internet. The Act had been broadly interpreted by DOJ to apply to and prohibit all forms of Internet gambling.

- **UIGEA** - Unlawful Internet Gambling Enforcement Act (UIGEA) of 2006
  - UIGEA focus is on financial institutions -- establishes penalties for banks and financial firms that process illegal Internet gambling payments
  - UIGEA doesn't define which specific games are illegal. Instead, it relies on existing state and federal laws, including the Wire Act and the Interstate Horseracing Act
  - Defines a bet as taking place where the player is located (removing argument of offshore operators)

- **DOJ Memo** - In December 2011, the DOJ changed its long-standing interpretation of the Wire Act:
  - "Interstate transmissions of wire communications that do not relate to a 'sporting event or contest' fall outside the reach of the Wire Act."
  - A game-changer: removed the Wire Act as a mechanism to prosecute illegal Internet gambling operators other than sports betting
  - The DOJ ruling also opened the door for states to pursue online gambling

Where is the law today? The states jump into the action post-2011

State Activity - State legalization in wake of DOJ memo was swift – differing models:

- Illinois began selling lottery tickets online in March 2012
- Georgia's online lottery program became operational in November 2012
- Nevada launched internet poker in April 2013, limited to NV licensees (licensed operators – 3 today)
- Delaware launched all forms of casino gambling in September 2013 (Lottery platform – with racinos managing portals on this platform)
- New Jersey followed shortly thereafter in November 2013 with all forms of gambling (limited to AC casino licensees)
- Many other states examining Internet gambling
- Nevada and Delaware entered into a multi-state Internet gaming agreement in February 2014 that allows players from each state to compete against each other

Illegal Activity – continues to thrive, with estimates that the market is $2 to $4 billion

Where is the law today? Most recent congressional activity

- **Efforts by a single casino operator to seek a prohibition – Bills filed in Senate (Graham) and House (Chaffetz) in April 2014**

- **The ban threat is very real - The impacts of a federal ban if enacted:**
  - states will have no ability to enact legislation that would authorize any form of internet gambling, including poker, and
  - the illegal environment operated by off-shore parties targeting Americans will stay in place with no consumer protections.

Overarching Policy Concerns

- **Internet poker is here to stay** -simple prohibition has not and does not work

- **Internet poker is an interstate activity** - No one can question the interstate nature of the Internet, so some form of federal involvement may make sense (such as law enforcement protections, setting minimum consumer protections and rules on rogue operators)

- **Whether the solution is state or federal, states should maintain their ability to define gambling policy -** States should be able to determine whether to prohibit online poker or regulate it – a basic function of state police powers – there remains an issue as to whether a state or the federal government should define what will be allowed.

➢**We strongly advocate state and federal laws working in tandem in a manner that:**

(i) respects the right of states to either prohibit or authorize Internet poker;

(ii) establishes strong consumer protection standards and strict regulatory controls; and

(iv) provides effective law enforcement tools to drive bad actors out of the marketplace

Specific Considerations for State Policy:

- **Allow licensed gaming operations in a state to offer Internet poker and/or RFP licenses**
  - Avoid the fate of other industries that have ignored the Internet (record industry, book stores)
  - Based on experiences to date in regulated U.S. jurisdictions, online poker is likely to increase – not cannibalize – overall revenues and taxes
  - Online poker will create cross marketing opportunities for licensees and improve distribution channels for operators to all customer segments
  - Online Poker will create a new stream of state revenues

- **In states that authorize, establish a strict regulatory framework and strong consumer protections** to:
  - Prevent minors from playing and deal with problem gambling (e.g., responsible gaming policies, limits on deposits, losses, and time)
  - Ensure that games are fair and honest -- strict regulatory scrutiny
  - Mandate a transparent record of all transactions to comply with laws on federal bank secrecy and suspicious transaction reporting

- **Empower law enforcement officials with stronger tools** to shut down the illegal sites (white lists, unambiguous crimes, seizure rights over domain names)

- **Allow states that offer Internet poker a new source of tax revenue** and capture state income taxes that currently are evaded

Operational Controls

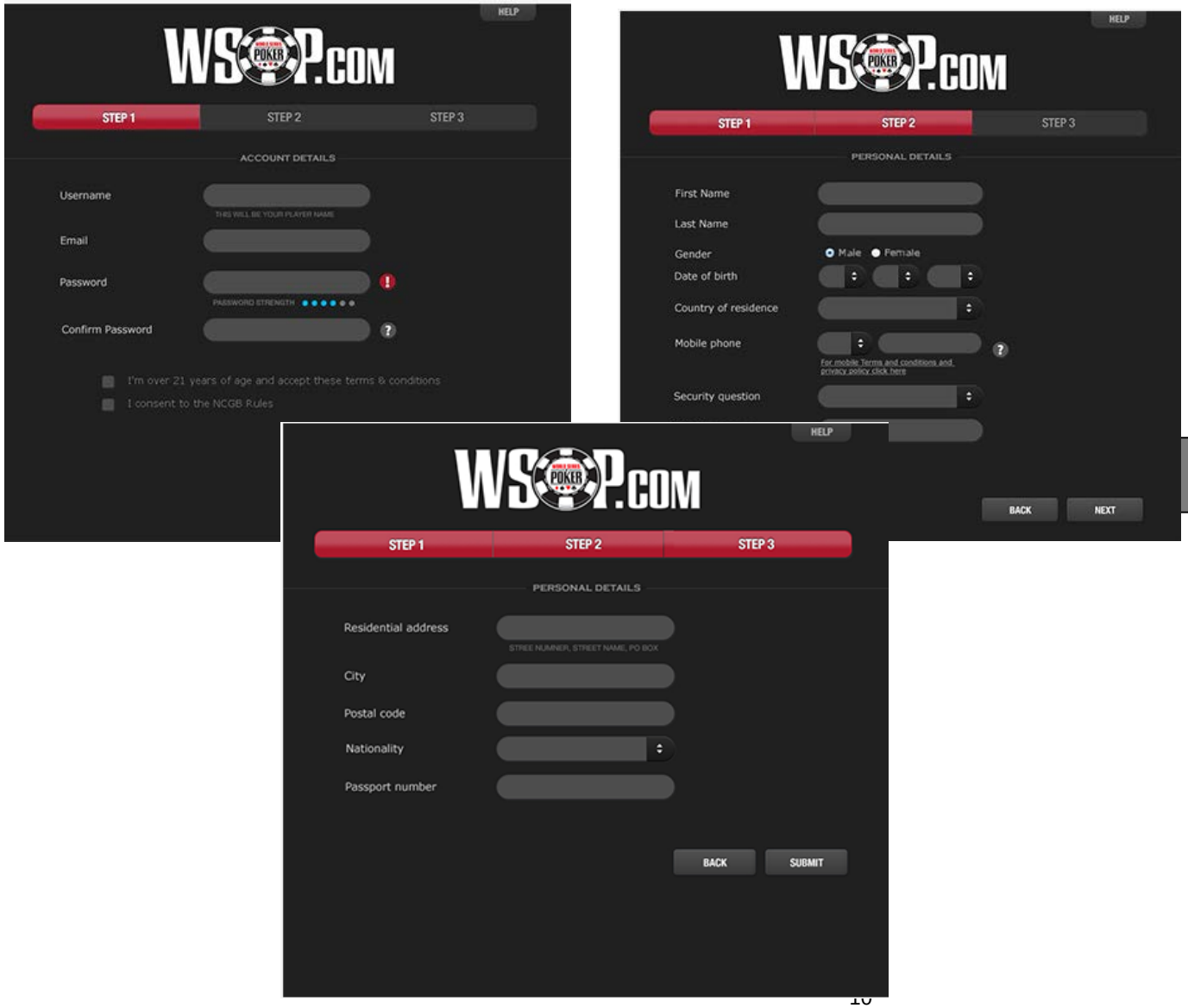
Operational Controls

- **Registration process**
- Payment Processing
- Fraud & Collusion
- Anti Money Laundering
- Responsible Gaming

Registration Process

This is a core requirement prior to any real money poker taking place

Should any of these checks fail the account will be placed into suspension



- Geo-location validation
- Responsible gaming check
- Age & ID verification
- Sanctions check

Registration Process

Geo Location

- Geo-location is defined as the identification of the real-world geographic location visitor
  - *Used to determine State and Country*
  - *Connection Type (eg: broadband or dial up connection)*
  - *whether a proxy server or anonymizer is being used and more*
- *We have been using both Cellular triangulation and WIFI triangulation as the core mechanisms for location control and player location*

Responsible Gaming

- Validation against "Self excluded list"
  - *Proprietary Operator List*
  - *Licensees brick and mortar self excluded list*

Age & ID

- By using leading third party providers we are able to determine the age and ID of a player in **real time**
- Player matching is done on full name, address, zip code and DOB to validate age and residency

Sanctions check

- *PEP: Worldwide Politically Exposed Persons*
- *DPL: Denied Persons List –US Dept. of Commerce.*
- *OFAC watch list – Office of Foreign Assets Control, US Department of Treasury*
- *Mortality check and more*

Registration Process

It is important to note that each year as technology evolves, new tools become available to assist in identifying and protecting consumers. While not yet in a format that can be implemented, the following technologies may have promise in the future:

- Face recognition software and tools
- GPS tracking through cellular phones

- Geo-location technology allows for the identification of the location of the players through two primary methods:

  - **Cellular triangulation** - refers to the attaining of the current position of a mobile phone, stationary or moving. Localization may occurs via GPS based on a GSM towers that are within the proximity of the cellular device at the time of geo-location.

  - **WIFI triangulation** - Wi-Fi positioning takes advantage of the rapid growth in the early 21st century of wireless access points in urban areas. The localization technique used for positioning with wireless access points is based on measuring the intensity of multi WIFI access points (more than 2 unique) signals received as "fingerprinting".

Operational Controls – they do work!

- Registration process
- **Payment Processing**
- Fraud & Collusion
- Anti Money Laundering
- Responsible Gaming

Payment Processing

- Each transaction is filtered through a sophisticated neural based payments rule engine that is built on a robust technology designed to insert, update or remove rules quickly

  - Velocity limits are configured to monitor if a predetermined volume of deposit attempts are made within a specific time scale
  - Highlight cases where there is a name discrepancy between the members' registration details and the name used on credit or debit cards
  - Automated rules for accounts where multiple different credit cards or e-payment methods are used
  - Perform negative and positive database checks
  - Flag accounts where there are unusual deposit patterns
  - Restrict user imposed deposit limits to aide with Responsible Gaming

Payment Processing

- Prior to a player's initial cash-out request being processed

  - Members will be required to fax or scan copies of their identification that match the account information on file

    -One must be a valid piece of picture identification (i.e. drivers license)

    -The other must demonstrate proof of residency which matches the member's address on file (i.e. phone bill, cable bill etc….)

Operational Controls

- Registration process
- Payments
- **Fraud & Collusion**
- Anti Money Laundering
- Responsible Gaming

Fraud & Collusion

- Fraud and Collusion rule sets function very similarly to payment processing authentification. They are independent rule sets that are triggered based on game play and player actions on the system. These rules out-sort and flag players:

  - Who regularly play at the same tables
  - Who frequently lose to the same members
  - Who potentially use unfair software to gain an advantage over other players
  - Who play for an amount of time that is deemed suspicious or “robotic”
  - Whose mouse clicks are in the same or nearly the same pixel area on the screen, i.e. clicking an action button in the same area consistently

- Reviewing game-play of members whose play is reported by others as being suspicious

Fraud & Collusion

- Chip dumping
  - Players are flagged depending on the amounts they have deposited in relation to their current balance and level of games played
  - Players who lose large amounts of money over a short period of time are identified as this represents the typical pattern of behavior for intentional chip-dumpers
- Collusion
  - An automated process runs on the poker platform to identify players acting “in concert,” highlighting players who have certain predetermined ratios with regards to hands played, raise ratios and rounds they play with the same players

Operational Controls

- Registration process
- Payments Processing
- Fraud & Collusion
- **Anti Money Laundering**
- Responsible Gaming

Anti Money Laundering

- In order to prevent money laundering, there are a number of reports and checks designed to identify possible money laundering activity

- The primary automated processes are:

    - Reviewing unusual deposit patterns
    - Reviewing unusual cash-out patterns
    - Identifying members who frequently play with the same members
    - Identifying members who frequently lose to the same members

- Should there be any evidence to support a suspicion of money laundering, the account shall be immediately suspended pending a full investigation

- Operators leverage Know Your Customer protocols

- Any suspicious findings will be submitted to proper authorities through the STR (suspicious transaction reporting)

It is very important to note that all deposits have wagering restrictions (for example, minimum number of hand requirements) so depositing a large sum and trying to cash-out without meeting these restrictions will automatically suspend the cash-out and place the account under review.

Operational Controls

- Registration process
- Payments
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- **Responsible Gaming**

Responsible Gaming

- Online poker technology provides players with the ability to manage their game play in real-time:

  - Setting *daily*, *weekly*, *monthly* deposit limits
  - Setting session limits to advise when a time threshold has been hit
  - Setting a cool-off period (i.e., a period of time during which they may not play)
  - Allowing players to self-exclude from the site for a defined period of time or forever ***it is important to note that this action is 100% irreversible***
  - Fully auditable transaction history (deposits and withdrawals and hand history)

Online Poker’s Importance for Licensees and the Commonwealth

Online poker will likely increase – not cannibalize – overall revenues and profits

Online poker has catalyzed growth in US offline markets

- Poker market in land-based casinos has grown since the onset of online poker
- Offline poker revenues have grown since the inception of online poker
- **CIE's NJ experience: 91 percent of online players are new customers; customers who weren't new increased land-based play by 11%**

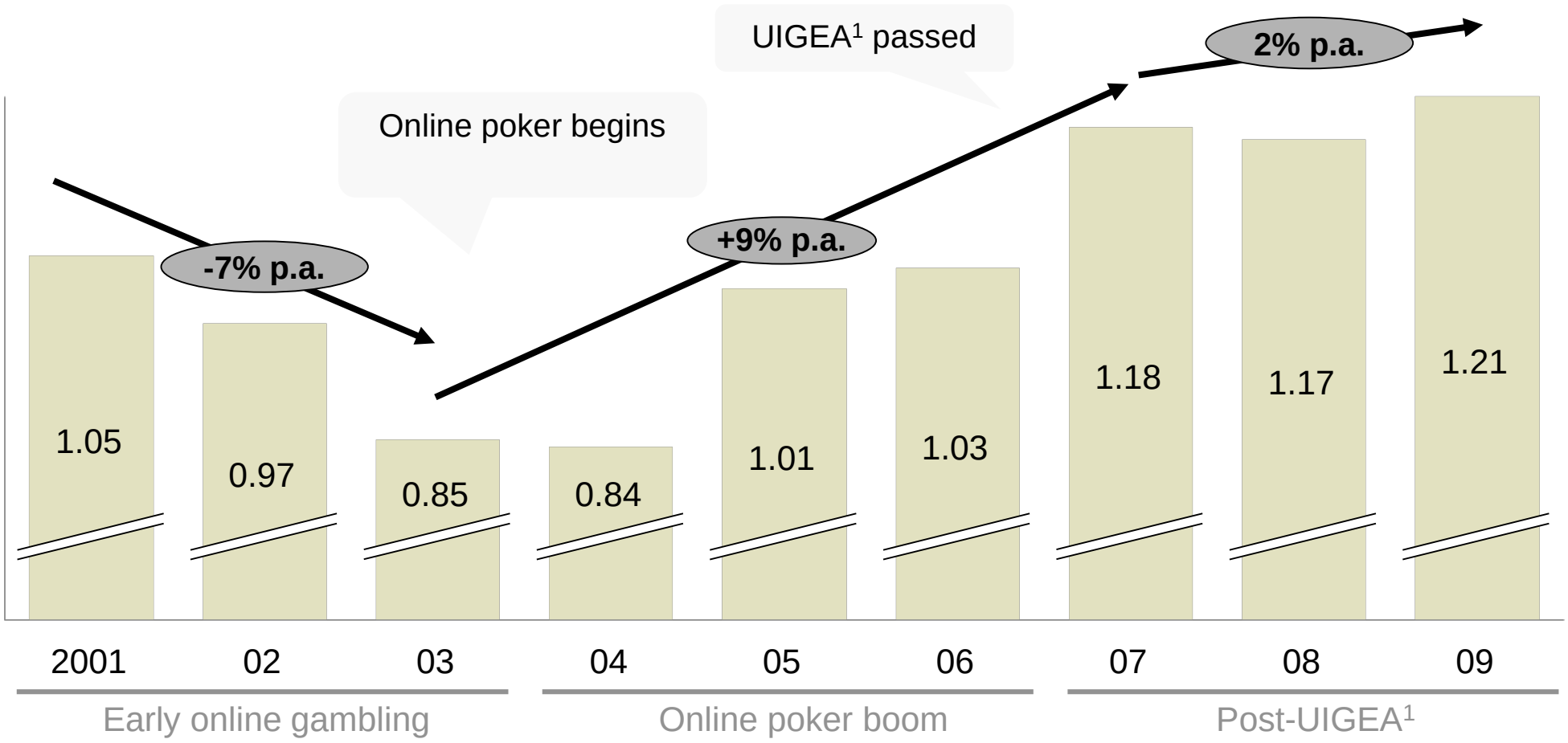
Retail experience shows that online drives sales overall

- Retailers that have embraced online channels have grown both online and offline
- Multi-channel shoppers are more valuable than single-channel shoppers
- Those retailers that have rejected the internet have faded (recording industry, newspapers etc.)

U.S. poker room market has grown since the onset of online poker

US card rooms yield

$ Billions



1 2006 Unlawful Internet Gambling Enforcement Act

SOURCE: H2 Gambling Capital

In retail, online formats have supplemented, not cannibalized, off-line revenues

Retailers who have successfully developed an online channel:

- *Encourage cross shopping because multi-channel customers are more loyal and spend more*
- *Segment their portfolio based on product type and purchase occasion*
- *Reduce cost to serve on less profitable customers*

JCPenney

- Online channel moves excess inventory w/ differential product & pricing
- Leverage online channel to offer additional breadth, when in-store economics do not make sense
- JCP shoppers that use all three channels (internet, retail, & catalog) spend ~$900 / year while single channels shoppers spend ~$200

WILLIAMS-SONOMA

- Relentless focus on cross-channel data & insights
- Catalogs drive 15% of store purchases
- 25%-30% lift in retail store sales when catalogs drop
- ~62.5% of Internet sales stem from catalog mailings

WAL★MART

- Encourage store visits by offering free shipping to store for items with low online penetration/high shipping costs
- 60% shoppers who pick up online items in-store purchase an additional $60 worth of goods during visit
- Cross-channel advertising with in-store circulars displaying online specials and access to in-store ads from Walmart.com

SOURCE: McKinsey analysis

While the 40+ age-group currently provides 85% of casino revenues, the gambling market is moving to a younger demographic They use the Internet to make decisions and have fun …

55% of people under 50 have looked for information on Wikipedia. Only 38% between 50-65 and 25% over 65 have used it[1]

Younger segments are ~1.5x more likely to use the internet to find information about a hobby or interest than older segments[2]

While ~70% of under-40 crowd uses social networks[4] (~45% heavy users) less than 10% of the over 50 population uses them

Nearly half of the under 40 population uses the internet to play games. Less than 1/4th of over 50 population do so

1 Q. Ever look for information on Wikipedia
2 Q. Ever look for information about a hobby or interest (Over 65: 52%; 18-29: 74%)
3 Q. Ever play online games
4 Q. Use online social or professional networking sites like Friendster or LinkedIn yesterday

What's all this mean for Pennsylvania?

- **Both the Commonwealth and its casino operators will benefit from regulated online poker**
  - Most of the industry has converged on a poker-only solution in order to grow Pennsylvania brick-and-mortar casino businesses
  - Independent analysis confirms the revenue potential for the Commonwealth – According to the May 2014 report by Econsult for the Pennsylvania Legislative Budget and Finance Committee:
    - The annual, **ongoing revenue potential for online poker in Pennsylvania is $129 million**.
    - The complementary effect of online poker on existing Pennsylvania casinos is approximately **6x** any cannibalization effect.

- **The market potential translates to an important new tax revenue stream for Pennsylvania**
  - Taxes both on operator revenues as well as capture of income taxes
  - But tax rates must be aligned with business realities
    - As Econsult indicates, the illegal market limits the ability to extract high tax rates, and an overly burdensome tax would reduce the positive spillover effect on existing casinos
    - The global online poker experience demonstrates that tax rates higher than 20% have stifled growth and adversely affected business sustainability

What's all this mean for Pennsylvania?

- **New research by H2 Gambling Capital confirms the Econsult findings**

  - The Pennsylvania online poker market is expected to gross between **$1.28bn -** or an average of **$128m / year** (base case), and **$1.96bn -** or an average of **$196m / year** (best case) over 10 years.
  - At a reasonable **14% tax rate**, the amount generated for the Commonwealth could be in the region of **$18m** (base case) to **$27-28m** (best case) per year.
  - An estimated upfront license fee - levied as an advance against tax - in the range of **$5m** is reasonable, and with up to 12 existing licensees applying equates to a potential advance tax total of **$60m.**
  - Based on evidence both from the United States, and around the world, regulated online poker in Pennsylvania is **unlikely** to cannibalize Pennsylvania's existing land-based casino market, and will help significantly to **eradicate** the existing illegal market.
  - A regulated online poker market in Pennsylvania will also deliver **player protection**, **security**, and **job creation** benefits to the Commonwealth.

Conclusions

Conclusion:

- Pennsylvania citizens illegally engage in Internet poker today with no consumer protections and no regulatory oversight
- The time to act on this is now, as other jurisdictions are moving forward and the threat of a congressional ban on state activity exists
- The technological and operational controls for online poker are state of the art and have a proven track record
- Legalization is important to Licensed Operators in the state to stay relevant with the “Internet generation” and to help create new marketing tools/channel of distribution
- The evidence from the U.S. and elsewhere supports the proposition that internet poker will not cannibalize existing revenues
- There is significant revenue potential for the Commonwealth